(University of Choice)

MASINDE MULIRO UNIVERSITY OF SCIENCE AND TECHNOLOGY (MMUST)

MAIN /BUNGOMA /WEBUYE /MUMIAS/KAPSABET/NAIROBI CAMPUS

MAIN EXAM

UNIVERSITY EXAMINATIONS 2018/2019 ACADEMIC YEAR

THIRD YEAR SEMESTER ONE EXAMINATIONS

FOR THE DEGREE OF BACHELOR OF COMMERCE

COURSE CODE: BCF 200

COURSE TITLE: FINANACIAL MANAGEMENT

DATE: Monday 28th January 2019 **TIME:** 8-10am

INSTRUCTIONS TO CANDIDATES

Attempt QUESTION ONE and any other two questions

TIME: 2 Hours

MMUST observes ZERO tolerance to examination cheating

This Paper Consists of 4 Printed Pages. Please Turn Over.

QUESTION ONE(30 MARKS)

a) Define the term "cost of capital" and give any two factors that affect level of cost of capital of a firm (3 marks)

b) Describe in brief the greatest difficulties faced in capital budgeting in the real world. (3 marks)

c) Discuss the goals of Financial Management and state the best goal (4 marks)

d) For each of the following situations explain the agency conflict inherent, the cost the firm might incur and the likely remedies:

i) The front desk receptionist routinely takes 20 minutes of lunch on her personal errands.

ii) Divisional managers are manipulating cost estimates in order to show short term efficiency gains.

iii) The firm's CEO has secret talks with a competitor about the possibility of a merger in which she would become CEO of the combined firms.

iv) A branch manager lays off experienced full-time employees and replaces them with temporary workers to lower employment costs. The manager's bonus is based on profitability of the branch. **(2 marks each= 8marks)**

e) Lukas wishes to determine the future value at the end of two years of a Sh.150,000 deposit made today into as account paying a nominal interest rate of 12%.

Find the future value of Lucas' deposit assuming that interest is compounded:

i. Annually
ii. Quarterly
iii. Monthly
iv. Continuously **(3 marks each=12 marks)**

QUESTION TWO (20 MARKS)

a) Explain why the weighted average cost of capital of a firm that uses relatively more debt capital is generally lower than that of a firm that uses relatively less debt capital. (5 marks)

b) Butali Milling Company purchased a grinder 3 years ago at a cost of Sh.3.5 million. The grinder had a life of 8 years at the time of purchase. It is being depreciated at 15% per year on a declining balance. The company is considering replacing it with a new grinder costing Sh.7 million with an expected useful life of 5 years.
Due to increased efficiency, the profit before depreciation is expected to increase by Sh.400, 000 a year. The old and new grinders will now be depreciated at 25% per year on a declining balance for tax purposes.
The salvage value of the new grinder is estimated at Sh.210, 000. The market value of the old grinder, today, is Sh.4 million. It is estimated to have a zero salvage value after 5 years.
The company's tax is 30% and the after tax cost of capital is 12%.
Required
Should the new grinder be bought? Explain. (15 marks)

QUESTION THREE (20 MARKS)

a. XYZ Ltd is considering three possible capital projects for next year. Each project has a 1-year life, and project returns depend on next year's state of the economy. The estimated returns are shown in the table

State of the economy	Probability of occurrence	Rate of Return A	B	C
Recession	0.25	10%	9%	14%
Average	0.50	14	13	12
Boom	0.25	16	18	10

Required:

i. Compute each projects expected rate of return (3 marks)
ii. Compute the standard deviation of each project (6 marks)
iii. Which is a better project? Why? (2 marks)

b. ABC Ltd total capital employed consists of the following:

1. Sh 50 million, 8% debt
2. Sh 100 milllion 12% preference stock capital. The par value and market price per share are Sh 100 and Sh 110 per share respectively
3. Sh 350 million ordinary share capital. The stock market price is Sh 50 per share. The firm paid a dividend of Sh 5 per share last year. Future dividends are expected to grow at 6% p.a
4. The company has retained earnings of Sh 100 million.

Additional information:
The corporate tax rate is 30%

Required:

i. Compute the firm's weighted average cost of capital (6 Marks)
ii. What are the weaknesses associated with WACC when used as the discounting rate, in project appraisal. (3 Marks)

QUESTION FOUR (20 MARKS)

a. Explain five determinants of a firm's dividend policy (5 Marks)

b. Supa Ltd has decided to acquire a piece of equipment costing Shs 240 000. The purchase will be financed with a 15% p.a loan requiring equal-year-end installments to be paid.
Required: prepare loan amortization schedule period 3yrs (5 Marks)

c. Sasa Ltd currently has an ordinary share capital of Shs. 40 million, consisting of 400,000 shares of Shs. 100 each. The management is planning to raise another Shs. 40 million to finance major program of expansion through one of the three possible financing plans. The plans are:

i. Entirely through ordinary shares.
ii. Shs. 20 million through ordinary shares and Shs. 20 million through long-term borrowing at 10 percent interest per annum.
iii. Shs. 15 million through ordinary shares and Shs. 25 million through long-term borrowing at 11% interest per annum.

The company's expected Earnings before Interest and Taxes (EBIT) will be Shs. 10 million.

Required: Assuming a corporate tax rate of 30%, determine the earnings per share (EPS) in each alternative and comment on the implications of financial leverage (6 Marks)

d. Calculate the yield to maturity (YTM) of a bond with a par value of Sh 1million and coupon rate of 12% paid annually. The bond is currently trading at a price of Sh 1.1 million and has 3 years remaining to maturity (4 Marks)

QUESTION FIVE (20 MARKS)

P. Muli was recently appointed to the post of investment manager of Masada Ltd. a quoted company. The company has raised Sh.8,000,000 through a rights issue. P. Muli has the task of evaluating two mutually exclusive projects with unequal economic lives. Project X has 7 years and Project Y has 4 years of economic life. Both projects are expected to have zero salvage value. Their expected cash flows are as follows:

Project	X	Y
Year	Cash flows (Sh.)	Cash flows (Sh.)
1	2,000,000	4,000,000
2	2,200,000	3,000,000
3	2,080,000	4,800,000
4	2,240,000	800,000
5	2,760,000	-
6	3,200,000	-
7	3,600,000	-

The amount raised would be used to finance either of the projects. The company expects to pay a dividend per share of Sh.6.50 in one year's time. The current market price per share is Sh.50. Masada Ltd. expects the future earnings to grow by 7% per annum due to the undertaking of either of the projects. Masada Ltd. has no debt capital in its capital structure. The discounting rate is 20%

Required:

a) The net present value of each project. **(7 marks)**

b) The Internal Rate of return (IRR) of the projects. (Rediscount cash flows at 24% for project X and 25% for Project Y). **(7 marks)**

c) Briefly comment on your results in (b) and (c) above. **(3 marks)**

d) Identify and explain the circumstances under which the Net Present Value (NPV) and the Internal Rate of Return (IRR) methods could rank mutually exclusive projects in a conflicting way. **(3 marks)**